

INFORMATION ABOUT TAX-EXEMPT STATUS

...FOR MAIN STREET PROGRAMS

In response to a number of requests, the National Main Street Center, (NMSC) a program of the National Trust for Historic Preservation, has prepared and updated several documents that may help local Main Street programs establish their tax-exempt status.

Choosing a Tax-Exempt Status for Your Main Street Program is an updated version of the article by McDuffie Nichols, NMSC, which appeared in the July, 1989 issue of Main Street News.

The Statement of Purpose for a Main Street Organization has been written so that it is consistent with the Model Response for IRS Form 1023. It may be suitable as a statement of purpose for bylaws or incorporation papers. The Statement of Purpose must be adapted to your local situation. Please consult an attorney to determine if your bylaws meet the requirements of the nonprofit status you are seeking from the IRS.

The Model Response for IRS Form 1023 is a new document. The NMSC has prepared a sample response to Part II, Question 1 on IRS Form 1023, "Activities and Operational Information," in order to demonstrate how to link Main Street activities and three charitable purposes: education, lessening the burdens of government and historic preservation. This model must be adapted to our local situation.

General Information

In order to qualify for 501(c)(3) status, a local Main Street organization must demonstrate to the IRS that its activities further a charitable or educational purpose.

There are four charitable purposes that are potentially served by Main Street organizations' activities: 1) public education; 2) lessening the burdens of government; 3) combating community deterioration; and 4) historic preservation.

A Main Street organization should make sure that its articles of incorporation specifically mention at least one of these purposes and that the description of its purposes and activities (Part II, question 1 on IRS Form 1023) explains how each of the organization's activities furthers one or more of these purposes. The articles of incorporation, bylaws and the description of purposes and activities on IRS Form 1023 need to be logically consistent. The program needs to prove that it was organized for a charitable purpose (through its articles of incorporation and bylaws) and is operated for a charitable purpose (based on the description of the programs and activities provided in Part II, question 1 on IRS Form 1023.)

Several words of caution are in order:

1. The Model Response for IRS Form 1023 must be modified to reflect the local Main Street program's actual purposes and activities. For example, if none of the buildings in your target area are either listed in, or eligible for listing, in the national, state or local inventory of historic sites or districts, you will probably not be able to argue that your activities further a historic preservation purpose. Each state or locality may have its own

criteria for eligibility, and these standards are available from the State Historic Preservation Officer.

2. Keep in mind that the IRS appears to consider economic revitalization activities as appropriate only for a Section 501(c)(3) organization whose purpose is to “combat community deterioration” within a target area that can objectively be considered blighted or depressed. Main Street programs cannot claim to “combat community deterioration” if their project area is not considered “blighted” by the IRS The IRS looks at a number of factors to determine whether a target area is “blighted.” These factors include whether the area has a higher unemployment rate than other towns in the state, or than the state as a whole; the number of vacant buildings in the target area; whether businesses in the area are unable to obtain conventional financing because the area is economically depressed; and whether the area has been formally designated as economically depressed by the state or the U. S. Department of Housing and Urban Development (HUD) for the purposes of obtaining state or federal assistance. If the Main Street program’s target area is considered blighted by the IRS, then “combating community deterioration” may be an appropriate activity code for the program. A number of Main Street organizations have had trouble with their applications for exemption, because they stated that their purpose was to “combat community deterioration,” but their project area was not considered “blighted” by the IRS. (We know of no case where a Main Street program’s 501(c)(3) exemption was revoked because its activities eliminated the blight that generated the program in the first place.)

3. Even if you follow this approach, there is no guarantee that you will succeed in obtaining Section 501(c)(3) tax exemption. For example, the IRS remains skeptical of the Main Street programs that provide technical assistance to downtown merchants on purely business marketing techniques. If this is a primary, rather than subordinate, activity of your organization, you may have trouble securing section 501(c)(3) status. Other potential “red flags” with the IRS include preferred membership status or privileges for local businesses or merchant associations.

4. If the district IRS office denies your 501(c)(3) application, you may appeal to the regional IRS office It is our recommendation that, if at all possible, the state Main Street program obtain the assistance of an attorney familiar with nonprofit tax and corporate law to help in reviewing your application to the IRS, drafting appropriate articles of incorporation and bylaws and in replying to IRS requests for additional information.

There are two primary benefits of securing Section 501(c)(3) status: individual donors can make tax-deductible charitable contributions, and the organization can receive foundation grants directly. However, if your objective is simply to obtain exemption from income tax, and you do not want or need 501(c)(3) status for fund-raising purposes, you may want to consider yourself tax exempt under Section 501(c)(4) as a civic/social welfare organization. It is not necessary to apply formally to the IRS for recognition of your section 501(c)(4) status, as long as you actually

qualify (although s IRS district offices encourage formal applications on Form 1024). An annual information return (Form 990) should be filed in any case.

CHOOSING A TAX-EXEMPT STATUS FOR YOUR MAIN STREET PROGRAM

Downtown revitalization organizations can take many forms. Some are set up as agencies of the local government; others, as quasi-governmental units. The majority of Main Street programs are established as private, tax-exempt nonprofit organizations. The status and activities of these groups are strictly regulated by section 501(c) of the Internal Revenue Code and have important implications for the mission and finances of the organization. A Main Street group's board of directors should closely examine the different classifications of 501(c) status, and make certain that the organization's nonprofit classification is consistent with its stated purposes and activities.

Section 501(c)(3)

Many downtown revitalization programs choose 501(c)(3) status for their organizations. Reasons for doing so are philosophical and financial.

Eight subcategories of activities qualify for (c)(3) classification: religious; scientific; testing for public safety; literary; groups that foster national or international amateur sports competition; groups that prevent cruelty to children or animals; charitable; and educational.

Philosophically, a Main Street program exists for the purpose of promoting downtown development within the context of historic preservation. The primary manner in which these organizations further their goals is through public education and community awareness of the Main Street four-point approach. Most Main Street programs that have sought nonprofit status have chosen to apply for exemption under section 501(c)(3) as charitable and/or educational groups.

The IRS used a broad legal definition of "charity" which includes:

- relief of the poor and distressed or underprivileged
- advancement of education or science
- lessening the burdens of government
- promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.

Educational purposes are also defined broadly by the IRS. Treasury regulations define education as "the instruction of the public on subjects useful to the individual and beneficial to the community."

As one would expect, the IRS places a number of restrictions on 501(c)(3) groups. To qualify for (c)(3) status, the organization must meet the following restrictions: "... no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is on propaganda, or otherwise attempting to influence legislation. ...and which does not participate in, or intervene in (including the

publishing or distributing of statements), any political campaign on the behalf of any candidate for public office.”

The restriction on lobbying is not a major drawback, however, as 501(c)(3) groups are allowed to engage in limited lobbying efforts. Such efforts might include testifying before a legislative committee; giving information, upon request, to committee members and staff; encouraging others to contact legislators; and sponsoring public forums.

Like all organizations, a 501(c)(3) group is required to file an annual report of its activities. 501(c)(3) organizations must file an annual Form 990 with the IRS, reporting total contributions of money, real property, negotiable securities and other revenues. The group could lose its tax- exempt status if it deviates from its exempt purpose, actively lobbies for legislation or operates to provide benefits to private shareholders or individuals. The organization might also lose its exemption for failure to meet the “public support” test.

In order to be classified as a public charity, the organization must satisfy a public support test to ensure that the organization doesn’t receive excessive support from any single private donor. Under the public support test, no more than one-third of any year’s contributions can come from donors whose gifts exceed the equivalent of 2 percent of the past five years’ gross revenues. Generally, the public support test must be met within five years of receiving 501 (c)(3) status.

In addition to the philosophical reasons, there are also financial incentives for seeking a 501(c)(3) designation. Exemption from federal income taxes is, of course, one advantage. Also, most states exempt 501(c)(3) organizations from paying property taxes.

Donations to 501(c)(3) groups are also deductible as charitable contributions by individual taxpayers. If there is a potential for such contributions in your commercial district, 501 (c)(3) status for the Main Street program may be the best option.

Moreover, most private foundations and federal grant programs will only award grants to 501 (c)(3) organizations. While there are ways to work with other 501 (c)(3) designated groups to obtain such grants, this is a factor that must be considered.

If a 501 (c)(3) Main Street organization decides to acquire real estate to provide income for its tax-exempt purpose, it may want to establish a separate 501(c)(2) entity. A 501(c)(2) organization is essentially a holding corporation organized exclusively to hold title to property, collect income from it and turn over the entire income (less expenses) to the 501(c)(3) group. A 501(c)(2) organization is also exempt from federal income tax, as long as it is not a corporation carrying on a business or trade for the benefit of, or on behalf, of tax-exempt organizations. Such “feeder” organizations are covered separately in Subsection 502 of the Tax Code, and are very strictly regulated.

Section 501(c)(4)

Section 501(c)(4) provides federal tax exemption to nonprofit civic leagues and organizations operated exclusively for the promotion of the social welfare. The net earnings of these groups are devoted exclusively to charitable, educational or recreational purposes.

There are similarities between 501 (c)(4) and 501 (c)(3) organizations. Both are organized to serve charitable and educational purposes, although 501(c)(4) status may also include recreational purposes. A group that could qualify as a 501(c)(3) would most likely be able to attain 501(c)(4) status as well.

There are, however, major differences between the two classifications. 501 (c)(4) organizations are permitted to engage in lobbying activities. A group classified by the IRS as an “action organization,” which would not be eligible for 501 (c)(3) status, could qualify for exemption under 501(c)(4). The only lobbying restriction on a 501(c)(4) group is that it cannot directly support or oppose a candidate for public office.

The ability to lobby notwithstanding, most Main Street groups will want to think carefully about the desirability of 501(c)(4) exemption. Contributions to 501(c)(4) organizations are not deductible as charitable contributions. A (c)(4) group’s inability to offer a charitable tax deduction to donors often outweighs the potential advantage of lobbying.

It is not necessary to apply formally to the IRS for recognition of your section 501(c)(4) status, as long as you actually qualify (although some IRS district offices encourage formal applications on Form 1024). An annual information return (Form 990) should be filed in any case.

Section 501(c)(6)

Section 501 (c)(6) of the U. S. Tax Code provides tax-exempt status to “business leagues, chambers of commerce, real estate boards, boards of trade or professional football leagues.. (that are) not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.”

The IRS requires that 501(c)(6) organizations be devoted to improving the conditions of one or more lines of business, rather than performing particular services for individuals. These groups must also be able to show that their members have a significant common business interest and that they have organized to implement a program designed to improve business conditions. Nationally, Main Street organizations have had little difficulty acquiring (c)(6) status.

One important point to remember about 501(c)(6) groups, however, is that they are considered to be primarily membership organizations. The group’s income should derive from membership dues and other activities “substantially related to its exempt purpose.” Contributions to 501(c)(6) organizations are not deductible as charitable donations. Certain contributions, however, can qualify as business deductions, if the donor can show that they are ordinary and necessary business expenses.

A 501(c)(6) organization can engage in unlimited lobbying activities as long as the activities promote the common business interests of the group’s members. Also, in addition to deducting the contributions that qualify as business expenses, members can deduct any portion of their membership dues attributable to permissible lobbying activities --i.e., activities in which the member has a direct interest.

Choosing a Tax Classification

One of the first issues a Main Street board of directors should address is that of tax classification status. If the organization existed before the Main Street program was formed, the board should reassess its activities to determine which status best fits the group. If the Main Street organization is new, the board can design its programs and structure to qualify for a particular tax classification.

When choosing a classification, consider all the requirements for that status. If the Main Street programs goals are primarily business oriented, a 501(c)(6) classification may be the best. A 501(c)(4) group, on the other hand, can serve a wider range of beneficiaries. Moreover, recognition of exemption under this section is relatively easy to obtain from the IRS.

The most closely monitored of the three classifications, 501(c)(3) status is not only the most difficult to attain; it also requires careful attention to remain within the exempt purposes allowed by the IRS. Despite the difficulty of obtaining 501(c)(3) status --and the fact that it may not be appropriate for every organization --it seems to be the preferred choice of most Main Street programs. Another possibility a Main Street program might consider is the formation of spin-off organizations. A spin-off group can provide flexibility, as well as take advantage of the maximum tax benefits for the Main Street program. For example, a 501(c)(6) or (c)(4) group could form a 501(c)(3) entity to carry out its charitable or educational goals, thereby reaching private contributors who would otherwise be excluded. Similarly, a 501(c)(3) could try the reverse to attract business contributors or to lobby more actively.

Applying for 501(c)(3) Classification

To obtain 501(c)(3) status, a Main Street program must conform to the legal requirements in that section of the Internal Revenue Code. This may sound easy, but a successful application demands close attention to every detail. Remember, the IRS uses certain requirements, or tests, when examining an application. Again, these tests are:

- The organizational and operational test. The group must be organized and operated exclusively for charitable purposes, as defined by law.
- The political and legislative activities test. The program must limit its political and legislative activities to those specifically allowed by the federal tax code. A 501(c)(3) organization is absolutely barred from all electioneering activities.
- No private benefit. No part of the net earnings can inure to the benefit of private shareholders or individuals.
- Public interest. The organization must benefit the public, not the private interests of a limited number of individuals.

Organizational and Operational Test

A Main Street program fulfills the requirements of the organizational and operational test by demonstrating to the IRS in its application --Form 1023, Part II, “Type of Entity and Organizational Documents” and Part III, “Activities and Operational Information” --that, in fact, it is organized and operated for charitable purpose(s). A Main Street organization must structure the language of these documents, and the program, to meet the requirements.

In a 1986 study for the National Main Street Center, Amy Haden, an intern from the West Virginia College of Law, reviewed applications, correspondence and supporting documents from a number of Main Street programs that had applied, both successfully and unsuccessfully, for 501(c)(3) status. Haden found that the IRS closely examines organizations that list economic development as one of their purposes.

For example, in a letter to the Batesville (Ark.) Main Street Program, the Atlanta District IRS office stated: “Economic development and promotion of business interest or the economic/financial interest of individuals is not, per Se, a charitable activity or purpose described in section 501(c)(3) of the Internal Revenue Code.”

The letter went on to say that “in order for an organization with purposes and activities designated to produce economic benefit to individuals and businesses to qualify for exemption under Code section 501(c)(3), it must be established that the individuals so benefited constitute a charitable class, or that the benefit provided... is incidental to the accomplishment of a charitable purpose, within the meaning of section 1-501 -(c)(3)- 1 (d)(2) of the Income Tax Regulations.”

In almost every case studied, the IRS raised the same objections: “Why do you feel you serve charitable, rather than civic or economic purposes?” In drafting language for the application, the Main Street organization must clearly demonstrate that the program’s purpose and activities serve charitable purposes or a charitable class. The Main Street program must show that its economic development activities are only a tool that it uses to achieve its charitable purposes. Economic development cannot be the primary: goal of the organization, because it is not a charitable purpose.

Charitable Purposes

Main Street programs fulfill four charitable purposes recognized in the Treasury regulations:

historic preservation; education; combating community deterioration; and lessening the burden of government. In its application, the Main Street program should emphasize that it serves more than one charitable purpose.

Historic Preservation An organization formed to promote historic preservation serves a charitable purpose. Activities that might further this purpose include preparing a survey of historic properties or a nomination to the National Register of Historic Places, providing design review assistance and giving architectural tours. In addition, in many cases, providing technical assistance to merchants or property owners on the topics of facade improvements or appropriate signs can further a historic preservation purpose.

Education The IRS defines education broadly to include “the instruction of the public on subjects useful to the individual and beneficial to the community.” Main Street programs’ educational activities should qualify under this definition. Examples of activities that further this charitable purpose include: architectural tours sponsored by the organization; lectures on town history and architecture sponsored by the Main Street organization; special events that educate the population about the history, culture and architecture of the downtown; and seminars on historic rehabilitations of downtown buildings.

Make it clear to the IRS that education is a primary purpose of the Main Street organization, and that such programming is provided to the public, not to an exclusive group.

Combating Community Deterioration Combating community deterioration in the charitable sense means to “. . .take remedial action to eliminate the physical, economic and social causes of deterioration.” The IRS must determine that the Main Street target area is “blighted,” and it uses a number of factors to make this determination. These factors include whether the area has a higher unemployment rate than other towns in the state, or than the state as a whole; the number of vacant buildings in the target area; whether businesses in the area are unable to obtain conventional financing because the area is economically depressed; and whether the area has been formally designated as economically depressed by the state or HUD, for the purpose of obtaining state or federal assistance. If the Main Street program’s target area is considered blighted by the IRS, then “combating community deterioration” is an appropriate charitable activity for the organization.

Lessening the burdens of government. Nonprofit organizations that carry out activities and programs ordinarily conducted by the government are considered by the IRS to serve a charitable purpose. Lessening the burdens of government includes activities such as researching common community problems, generating construction and restoration projects and assisting in other economic activities which create jobs, augment the local tax base and protect the public’s investment in infrastructure.

The appropriate “activity codes” for these charitable purposes, for the purpose of responding to Part I, question 7 on IRS Form 1023, are:

- 119 -other cultural and historic activities
- 379 -other conservation, environmental or beautification activities
- 149 -other instruction or training.
- 402 -other activity aimed at combating community deterioration

Meeting Other IRS Requirements

To meet the lobbying restrictions of 501(c)(3) status, a Main Street program should insert the following provision in its Articles of Incorporation: “The Corporation shall not engage in the carrying on of any propaganda or attempt to influence legislation, and the Corporation shall not participate in or intervene in any political campaign on behalf of any campaign of any candidate for public office.”

The Main Street program's Articles of Incorporation should also contain two clauses that demonstrate to the IRS that no part of the net earnings will inure to the benefit of a private shareholder or individual. The first clause should clearly prohibit the use of earnings for private gain; the second, known as the dissolution clause, ensures that the assets of the corporation will be permanently dedicated to an exempt purpose under section 501(c)(3).

The Main Street program's activities must benefit public, not private, interests. The problem for a commercial revitalization program is that it often appears to benefit only downtown merchants, businesses and property owners, not the general public. To prove otherwise, the Main Street program must show that it sponsors activities that include and benefit the entire community, and its membership must be open to the public.

It is important to remember that retail promotional activities are not charitable activities. Care should be taken to clearly differentiate retail activities from special events and image promotions.

Before applying for Section 501(c) tax-exempt classifications, a Main Street program must carefully review the purpose and activities of its organization. The benefits -- and limitations -- of each IRS classification should be thoroughly discussed by the board of directors, in consultation with a tax attorney and/or certified public accountant.

The decision poses philosophical, structural and financial questions which go to the very core of the Main Street program. Is Main Street an economic development program that focuses on the business interests of merchants and property owners and directly benefits only a few? Or does the program pursue a higher purpose, improving the quality of life for the entire community? Both questions should be answered not only to the satisfaction of the Internal Revenue Service, but also to that of the community at large.